Internal Revenue Service

memorandum

CC:INTL-0699-90
Br1:WEWilliams

date: JAN 22 1991

to: Mr. Dave Reinig, International Examiner
Dallas District

from: Senior Technical Reviewer, Branch No. 1
Associate Chief Counsel (International)

subject: Effect on Foreign Income Taxes, and Foreign Tax Credits, Resulting From Section 482 Adjustments
Taxpayer: [redacted]

THIS DOCUMENT INCLUDES STATEMENTS SUBJECT TO THE ATTORNEY-CLIENT PRIVILEGE. THIS DOCUMENT SHOULD NOT BE DISCLOSED TO ANYONE OUTSIDE THE IRS, INCLUDING THE TAXPAYERS INVOLVED, AND ITS USE WITHIN THE IRS SHOULD BE LIMITED TO THOSE WITH A NEED TO REVIEW THE DOCUMENT FOR USE IN THEIR OWN CASES.

This responds to your memorandum dated December 5, 1986, in which you request our informal advice concerning issues that have arisen with regard to I.R.C. § 482 allocations that you are considering making in this case.

Background

As we understand the facts, taxpayer, [redacted], has two wholly-owned foreign subsidiaries, [redacted] in the U.K. (hereinafter referred to as [redacted]) and [redacted] in Germany (hereinafter referred to as [redacted]). [redacted] and [redacted] are engaged in the fabrication, assembly, and testing of [redacted] pursuant to licenses from taxpayer. During the years [redacted] and [redacted], [redacted] and [redacted] paid taxpayer royalties amounting to less than [redacted] percent of each subsidiary's gross sales. The Service has evidence that other foreign subsidiaries of taxpayer, performing functions comparable to those of [redacted] and [redacted], pay taxpayer royalties of from [redacted] to [redacted] percent of gross sales. While you have requested that taxpayer provide information to support the reasonableness of the amount of the royalties paid by [redacted] and [redacted], taxpayer has not provided such documentation.

The statute of limitations on assessment for [redacted] and [redacted] expires [redacted], and taxpayer has refused to grant a further extension. Therefore, the Service is considering issuing a statutory notice to taxpayer determining a deficiency based on "protective" section 482 allocations of

royalty income from [redacted] and [redacted] to taxpayer. You have informally advised us, however, that subsequent to sending your memorandum you have discovered that the licenses that taxpayer gave to [redacted] are different than those given to [redacted] and that the royalties paid by [redacted] were probably reasonable. Apparently, the largest portion of any adjustment, in any event, would be with respect to an allocation of royalties from [redacted] to the taxpayer. However, we will address your questions with respect to [redacted] even though you may ultimately decide not to make an allocation of income from this subsidiary.

You have requested advice as to the effect that an allocation of royalty income to taxpayer will have on the computation of taxpayer's deemed-paid foreign tax credit under section 902. The formula for computation of the deemed-paid credit attributable to distributions out of earnings and profits of tax years beginning before January 1, 1987, is as follows:

Dividends (without regard to § 78) / Accumulated profits (as defined in § 902(c)(1)(A) in excess of income taxes paid)	X	Foreign income taxes paid	=	Foreign income taxes deemed paid

If, for purposes of computation of taxpayer's deemed-paid tax credit, the amount of income taxes paid to the U.K. and Germany is not reduced by the amount of the taxes paid on any income allocated to taxpayer under section 482, the deemed-paid tax credit to which taxpayer is entitled will, as a general rule, increase because of the reduction of accumulated profits in the denominator of the fraction by the amount of the income allocation. If the amount of foreign income taxes paid (i.e., the multiplicand of the formula) is not reduced as a result of the allocation of income, the foreign tax credit may be increased, thereby offsetting the increased tax liability caused by the section 482 allocation. Accordingly, you state that you probably will not make a section 482 allocation unless you are reasonably sure that the foreign income taxes paid will be proportionately reduced.

You request our advice on the following questions:

1. For purposes of computing the deemed-paid credits, can the amount of foreign income taxes paid by [redacted] and [redacted] in [redacted] and [redacted] be reduced regardless of whether the statutes of

limitation on claiming refund have expired on the [redacted] and [redacted] and [redacted] foreign income tax returns?

2. Do the U.K. and German competent authorities have the authority to waive the statute of limitations in section 482 cases? Under what conditions?

3. If taxpayer agrees to a section 482 allocation of royalty income from [redacted] and [redacted], can the examiner be assured that the foreign taxes paid by the subsidiaries will be reduced in proportion to the royalty amount even though the statutes of limitations on [redacted] and [redacted]'s foreign income tax returns has expired?

4. Do the laws of the U.K. and Germany provide for arm's length pricing in computing income tax liability?

Discussion

Issue 1 - For purposes of computing the deemed paid credits, can the amount of foreign income taxes paid by [redacted] and [redacted] in [redacted] and [redacted] be reduced regardless of whether the statutes of limitations on claiming refund have expired on the [redacted] and [redacted] and [redacted] foreign income tax returns?

In Rev. Rul. 74-158, 1974-1 C.B. 182, the Service made a section 482 allocation of income from a foreign subsidiary to its U.S. parent; the allocation caused a correlative increase in the expenses of the subsidiary. Rev. Rul. 74-158 explains that the U.S. parent's deemed-paid foreign tax credit is calculated, after the allocation of income, by decreasing accumulated profits in the denominator of the deemed-paid credit fraction by the amount of the allocation. Because the allocation did not affect the amount of foreign taxes paid by the subsidiary, this part of the fraction was not changed. A critical distinction between the facts in the Revenue Ruling and the facts in your case is that the U.S. and the country in which the subsidiary was located did not have an income tax treaty.[1]/

Rev. Rul. 74-158 was clarified in Rev. Rul. 76-508, 1976-2 C.B. 225. The facts in Rev. Rul. 76-508 are very similar to the facts in your case. In Rev. Rul. 76-508, the Service allocated income from a foreign subsidiary to its U.S. parent

[1]/ Although Rev. Rul. 74-158 is silent as to whether there is any applicable treaty, Rev. Rul. 76-508 states that under the facts in Rev. Rul. 74-158 there was no treaty.

under section 482. The allocation had the effect of reducing the subsidiary's income by the amount of the allocation and, in contrast to Rev. Rul. 74-158, this reduction in income could appropriately have reduced the subsidiary's foreign tax liability by operation of the tax treaty between the U.S. and the country in which the subsidiary was located. The subsidiary did not seek a refund of tax from the foreign country as a result of the allocation, nor did the U.S. parent request competent authority assistance under the tax treaty. The revenue ruling concludes that since neither the taxpayer nor its subsidiary exhausted all effective and practicable administrative remedies in seeking a refund of the foreign tax paid on the allocated income, the amount of taxes paid to the foreign country are reduced by the deemed overpayment for purposes of computing the section 902 credit. The ruling treats a request for competent authority assistance as an administrative remedy that must be exhausted before credit for tax paid on the income allocated to the U.S. parent may be included in computation of the deemed-paid credit.

Support for the conclusions in Rev. Rul. 76-508 is found in section 1.901-2(e)(5) of the Treasury Regulations. This Regulation provides, in part, that an amount paid to a foreign government will not be considered to exceed the liability under foreign law for tax if the taxpayer exhausts all effective and practical remedies, including any available competent authority procedures under applicable tax treaties, to reduce the taxpayer's liability for foreign tax. If a taxpayer is aware (whether as a result of a proposed adjustment by the Service under section 482 or otherwise) of the possibility of securing a refund or reduction of foreign income tax liability but fails to pursue its remedies to secure such an adjustment, the amounts for which no adjustment was sought may be treated as noncompulsory payments to the foreign government. See Treas. Reg. § 1.901-2(e)(5), Example 2; and Kenyon Instrument Co. v. Commissioner, 16 T.C. 732 (1951), which held that state franchise taxes were not deductible to the extent that at the time of payment the taxpayer knew that it was not liable to pay them.

Accordingly, it is Service position that, for purposes of calculating the deemed-paid credit under section 902, the amount of foreign tax paid is reduced by the amount of foreign tax paid on income allocated from the foreign subsidiary to a U.S. taxpayer, unless the taxpayer establishes that the foreign tax payment was not a voluntary payment. To establish that the tax payment was not voluntary, the U.S. taxpayer and its subsidiary must exhaust all effective and practicable remedies and fail to obtain a refund of such tax. All

effective and practical remedies include requesting competent authority assistance, if available, as well as taking advantage of administrative procedures under the foreign law for contesting a tax liability. Thus, a payment is considered voluntary if a taxpayer is notified of a possible section 482 allocation, and thus of the possibility of securing a refund or reduction of foreign income tax, prior to expiration of the statute of limitations under foreign law for contesting a tax liability, but nevertheless takes no available action to protect the statute (e.g., a protective claim for refund). Failure to seek available competent authority assistance, whether prior to or after the expiration of the foreign statute of limitations, will also cause a payment to be considered voluntary.

On the facts that you have given us, we cannot determine whether [redacted] or [redacted] exhausted all effective and practicable administrative remedies for obtaining a tax refund from the U.K. and Germany. If taxpayer was notified that the Service was considering allocating income to it from [redacted] and/or [redacted], before expiration of the U.K. and German statutes of limitations on claiming refunds, and [redacted] or [redacted] did not file protective claims, it is our view that all practicable procedures were not pursued to establish that the tax was not a voluntary payment. As explained above, the amount of taxes paid in the deemed-paid formula may be reduced by amounts deemed to be voluntary payments. However, as discussed below and if the allocations are actually made, taxpayer may still be able to contest the foreign tax payments through competent authority procedures, at least with respect to Germany.

Therefore, under some factual circumstances, the amount of foreign taxes paid, for purposes of the deemed-paid credit formula, will be reduced as a result of a section 482 allocation, even though at the time of the allocation the statute of limitations on obtaining a refund of such taxes has expired.

Issue 2 - Do the U.K. and German competent authorities have the authority to waive the statute of limitations in section 482 cases? Under what conditions?

U.K.

Article 9(1) of the U.K. - U.S. Income Tax Convention expressly provides for allocations of "income, receipts, or outgoings" between "associated enterprises" when transactions between these enterprises are not conducted on a basis that would have prevailed between "independent enterprises".

Article 9(2) of the Convention directs that adjustments in tax liability should be made as a result of appropriate adjustments under Article 9(1). Article 9(2) provides as follows:

> (2) Where any income, deductions, receipts, or outgoings which have been taken into account in one Contracting State in computing the profits or losses of an enterprise are also taken into account in the other Contracting State in computing the profits or losses of a related enterprise in accordance with paragraph (1) of this Article, then the first-mentioned State shall make such adjustment as may be appropriate to the amount of tax charged on those profits in that State.

The Treasury Department's Technical Explanation of Article 9(2) is as follows:

> Paragraph (2) sets forth an explicit formulation of the consequence of a redetermination made in accordance with paragraph (1) by a Contracting State. In such event, the other Contracting State shall make such corresponding adjustment as may be appropriate to the amount of tax charged to the related enterprise by the other Contracting State. In the case of the United States, assuming application within a reasonable time after notice of such adjustment, any refunds of tax in respect of such an adjustment shall be made notwithstanding the statute of limitations.

Article 9(3) of the Convention provides that if a Contracting State disagrees with an adjustment made by the other State under Article 9(1), the States will attempt to resolve the disagreement under the mutual agreement procedure in Article 25 of the Convention.

While the Treasury Department's Technical Explanation of Article 9(2) of the Convention explicitly states that the U.S. competent authority may, in some cases, waive the statute of limitations, we have been advised by the Office of Tax Treaty and Technical Services, in the Office of the Assistant Commissioner (International), that the U.K. Competent Authority takes the position that he does not have the power to waive the statute of limitations and will not accept a case for mutual agreement assistance if the U.K. statute of limitations has expired.

Germany

Article VIII(5) of the 1954 U.S. - Germany Income Tax Convention contains an authorization for allocations of royalty income between associated enterprises to reflect what would have been agreed upon by enterprises that are not associated. In contrast to the U.K. Convention, the 1954 German Convention contains no specific provision for adjustment of tax liabilities based on allocations of income under Article VIII(5) that are agreed to by the two countries.[2]/ However, under the mutual agreement procedure in Article XVII of the 1954 Convention, the competent authorities have the power to resolve double tax cases and to adjust tax liabilities to reflect such agreements. In this regard, Article XVII states that in resolving double tax cases "taxes shall be imposed ..., and refund or credit of taxes shall be allowed, by the contracting States in accordance with such agreement." Thus, Article XVII gives the competent authorities the power to adjust tax liabilities in connection with the mutual agreement process.

We have been advised by the Office of Tax Treaty and Technical Services that the German Competent Authority has the power to waive statutes of limitation in connection with the mutual agreement process. Thus, a case will not necessarily be refused by the German Competent Authority because the German statute of limitations on claiming a refund has expired.

The U.S. and Germany are expected to exchange instruments of ratification during December 1990, for an income tax convention signed August 29, 1989. The new Convention will supersede the 1954 Convention and will be effective generally for taxable years beginning on or after January 1, 1990. Since the years in issue in this case are [redacted] and [redacted], the 1954 Convention will apply whether the new Convention comes into effect or not.

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[2]/ Article 12(4) of the new Convention contains a provision almost identical to Article VIII(5) of the 1954 Convention. However, Article 9 of the new Convention, entitled Associated Enterprises, is substantially the same as Article 9 of the U.K. Convention and specifically provides for adjustments of tax liabilities resulting from income allocations agreed to by the two States.

Issue 3 - If taxpayer agrees to a section 482 allocation of royalty income from [redacted] and [redacted], can the examiner be assured that the foreign taxes paid by the subsidiaries will be reduced in proportion to the royalty amount even though the statutes of limitations on [redacted] and [redacted]'s foreign income tax returns has expired?

If taxpayer were to agree to allocation of additional royalties to it from [redacted] and/or [redacted], the result is that such income would be subject to double taxation, unless the U.K. and Germany allow correlative adjustments to the subsidiaries' tax liabilities. Whether a correlative adjustment to tax liability is permitted by U.K. and Germany will depend first on whether these countries agree that the IRS's allocation of income is appropriate. If such agreement is reached, the tax adjustment will be permitted by Inland Revenue, through a claim procedure or the competent authority process, only if the statute of limitations on claiming a refund is still open. If the statute of limitations on claiming a refund under German law has expired, the tax adjustment may still be permitted by the German Competent Authority through the mutual agreement process. However, there is no guarantee that either the U.K. or German tax administrations will agree that royalty allocations made by the IRS are necessary to reflect what would have prevailed between taxpayer and its subsidiaries if the parties had been dealing at arm's length. Therefore, there is no guarantee that the U.K. and Germany will agree to a reduction in the tax liabilities of [redacted] and [redacted] based on an allocation made by the IRS.

Issue 4 - Do the laws of the U.K. and Germany provide for arm's length pricing in computing income tax liability?

As discussed above, the U.K. and 1954 German Tax Conventions provide for determination of royalty income, paid by an enterprise to an associated enterprise, on an arm's length standard. Furthermore, Article 12(4) of the proposed new German Convention, essentially the same as Article VIII(5) of the 1954 Convention, is nearly identical to Article 9 of the U.K. Convention.[3]/ In this regard, Treasury's Technical Explanation of the new German Convention, in describing Article 12(4) states that

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[3]/ As noted above, Article VIII(5) of the 1954 German Convention does not explicitly provide for adjustment of tax liabilities as a result of allocations of income, deductions, etc.

> in cases involving special relationships between the payor and beneficial owner of a royalty, Article 12 applies only to the extent of royalty payments that would have been made absent such special relationships (i.e., an arm's-length royalty payment). [Emphasis added.]

Moreover, the arm's length standard for pricing transactions between related entities is contained in the tax laws of both the U.K. and Germany.

U.K.

Section 770(1) of the Income Tax Act of 1988 (ICTA) provides that, subject to special provisions for petroleum companies in section 771 of the ICTA,

> where any property is sold and-
>
> (a) the buyer is a body of persons over whom the seller has control or the seller is a body of persons over whom the buyer has control or both the buyer and the seller are bodies of persons over whom the same persons has or have control; and the property is sold at a price ("the actual price") which is either-
>
> (i) less than the price which it might have been expected to fetch if the parties to the transaction had been independent persons dealing at arm's length ("the arm's length price"), or
>
> (ii) greater than the arm's length price,
>
> then, in computing for tax purposes the income, profits or losses of the seller where the actual price was less than the arm's length price, and of the buyer where the actual price was greater than the arm's length price, the like consequences shall ensue as would have ensued if the property had been sold for the arm's length price.

This section applies to rentals; grants and transfers of rights, interests or licenses; loan interest; patent royalties; management fees; payments for services; and payments for goods.

A Note issued by Inland Revenue contains the following:

> In ascertaining an arm's length price the Inland Revenue will often look for evidence of prices in similar

> transactions between parties who are in fact operating at arm's length. They may however find it more useful in some circumstances to start with the resale price of the goods or services etc. and arrive at the relevant arm's length purchase price by deducting an appropriate mark-up. They may find it more convenient on the other hand to start with the cost of the goods or services and arrive at the arm's length price by adding an appropriate mark-up. But they will in practice use any method which seems likely to produce a satisfactory result.

Germany

Article 1(1) of the Foreign Tax Affairs Law states that where the income of a taxpayer resulting from his business relationship with a related person is reduced because the taxpayer has, within his business relationship extending to a foreign country, agreed on terms and conditions which deviate from those which unrelated third parties would have agreed upon under the same or similar circumstances, then his income shall, notwithstanding other provisions, be so determined as such income that would have been earned under terms and conditions agreed upon between unrelated third parties. Article 1(1) applies to all related or affiliated taxpayers, including individuals, partnerships, and corporations. A similar provision for transactions between related domestic corporations is found in Article 8(3) of the Corporation Tax Law.

A statement of "Administrative Principles" issued by the Ministry of Finance on February 23, 1983, contains the following with respect the arm's length requirement for royalties:

> 5.1.1. If an intangible property right ... is licensed for use by an affiliated enterprise, then the uncontrolled price has to be charged.
>
> * * *
>
> 5.2.2. The uncontrolled prices for the licensing of the intangible property rights have to be calculated, in principle by charging royalties on the basis of an appropriate key (e.g., sales, quantity, one time royalty).

A copy of the statement of Administrative Principles is attached.

Therefore, the arm's length standard for evaluating transactions between related parties is contained in the laws of the U.K. and Germany and is administered by the tax authorities of these countries in a manner similar to the way the IRS administers section 482.

Conclusions

Issue 1 - In order to establish that the taxes paid by [redacted] and [redacted] on any income that you allocate from these subsidiaries to taxpayer were not voluntary payments, taxpayer must show that it and its subsidiaries exhausted all effective and practicable remedies and failed to obtain a refund of the taxes. Effective and practicable remedies include administrative procedures available to [redacted] and [redacted] for claiming tax refunds from the U.K. and Germany. Such remedies also include requests by taxpayer for competent authority assistance under the U.K. and German treaties. If taxpayer cannot establish that the tax payments to the U.K. and Germany were not voluntary, foreign taxes paid for purposes of the deemed-paid credit formula will be reduced by the amount of the voluntary payments, regardless of whether the statutes of limitations on refund claims have expired in the respective countries.

Issue 2 - The U.K. competent authority takes the position that he does not have the authority to waive the U.K. statute of limitations on refund under any circumstances. Therefore, he will not accept a case of this type for mutual assistance when the statute of limitations has expired. In contrast, the German competent authority exercises his power to waive the statute of limitations and will do so if he agrees with a U.S.-initiated allocation of income from a German to a U.S. taxpayer.

Issue 3 - There is no guarantee that the U.K. and Germany will reduce [redacted] and [redacted]'s tax liabilities to correspond to IRS-initiated allocations of income. Under the mutual agreement procedures in the U.K. and German Conventions, the competent authorities of these countries are not required to accept the IRS adjustments. In the case of the U.K., the U.K. competent authority will not even consider a case if the statute of limitations for obtaining a refund has expired.

Issue 4 - The laws of both the U.K. and Germany contain arm's length pricing standards for evaluating transactions between related entities; these laws are similar to I.R.C. §

482. Also, the tax administrations of the U.K. and Germany administer their laws in a manner similar to the way the Service administers section 482.

We hope that this memorandum is responsive to your questions. If we can be of further assistance, please call Ed Williams at FTS 287-4851.

/s/
KENNETH W. WOOD

Attachment:
Copy of "Administrative Principles"